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Financial Value Implications of Employing the Client Maintenance System

Professional practices are valued based on intangible assets instead of tangible assets. Therefore, their value tends to be very dependent on earning capacity.

Income Approach to valuation is based on two main inputs:

1. Anticipated future cash flows available to owners derived from company assets (goodwill)
2. The risk associated with generating those cash flows (discount rate)

If you can increase the size of your cash flows, how long you continue to generate those cash flows and lower the unpredictability (risk) associated with those cash flows, you will increase the value of your firm.

The Client Maintenance Systems addresses the following fundamental Value drivers in a professional practice:

- Practice Size
- Persistence of customer (recurring visits)
- Earnings stability and predictability
- Dependence on key staff members
- Contractual Agreements
- Breadth and dependence on referral sources
- Reputation
- Facilities and technology
- Level of documented procedures
- Level of profitability as compared to peers
- Level of competition and differentiating factors including fee structures
- Marketability issues – Separation of practice and professional goodwill

Practice vs. Professional Goodwill

With no significant tangible assets, a law practice's ability to generate cash flows is derived from goodwill. There are two types of goodwill: Practice goodwill and Professional goodwill – Only practice goodwill is easily transferrable to a buyer. The Client Maintenance System effectively converts a portion of the professional (personal) goodwill into practice goodwill. This increases the sale value of the practice by:

- Increasing the future cash flows available to a buyer of your practice
- Extending the life of the practice following the departure of the seller
- Lowering the risk (discount rate) associated with generating future cash flows

Example 1 – Before the Client Maintenance System. Sole practitioner generating \$800,000 in revenue and a 25% profit margin. Assume 25% practice goodwill and 75% professional goodwill with a 50% attrition rate. Also assume a discount rate of 17% and a constant growth rate of 3%.

| Sales In Base Year | | 800,000 | | | | | |
|------------------------------------|-----|----------------|----------------|----------------|----------------|----------------|----------------|
| Constant Growth Rate | | 3% | | | | | |
| Rate To Compute Present Worth | | 17% | | | | | |
| Rate To Compute Terminal Value | | 14% | | | | | |
| | | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| Sales derived from: | | | | | | | |
| Professional Goodwill | 75% | 600,000 | 618,000 | 309,000 | 154,500 | 77,250 | 38,625 |
| Less Attrition | 50% | - | (309,000) | (154,500) | (77,250) | (38,625) | (19,313) |
| Total Professional Goodwill | | 600,000 | 309,000 | 154,500 | 77,250 | 38,625 | 19,313 |
| Practice Goodwill | 25% | 200,000 | 206,000 | 212,180 | 218,545 | 225,102 | 231,855 |
| Total Sales | | 800,000 | 515,000 | 366,680 | 295,795 | 263,727 | 251,167 |
| Profit (Cash Flow) | 25% | 200,000 | 128,750 | 91,670 | 73,949 | 65,932 | 62,792 |
| <i>Present Value Factor</i> | | | 0.92 | 0.79 | 0.68 | 0.58 | 0.49 |
| Present Value Of Net Cash Flow | | | 118,450 | 72,419 | 50,285 | 38,240 | 30,768 |
| Cumulative Present Value | | | | | | | 310,162 |
| Present Value Of Terminal Value | | | | | | | <u>226,365</u> |
| Indicated Value of Equity | | | | | | | 536,527 |

Example 2 – After the Client Maintenance System. Sole practitioner generating \$800,000 in revenue and a 25% profit margin. Assume 50% practice goodwill and 50% professional goodwill with a 50% attrition rate. Also assume a discount rate of 15% and a constant growth rate of 3%.

| Sales In Base Year | | 800,000 | | | | | |
|------------------------------------|-----|----------------|----------------|----------------|----------------|----------------|------------------|
| Constant Growth Rate | | 3% | | | | | |
| Rate To Compute Present Worth | | 15% | | | | | |
| Rate To Compute Terminal Value | | 12% | | | | | |
| | | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| Sales derived from: | | | | | | | |
| Professional Goodwill | 50% | 400,000 | 412,000 | 206,000 | 103,000 | 51,500 | 25,750 |
| Less Attrition | 50% | - | (206,000) | (103,000) | (51,500) | (25,750) | (12,875) |
| Total Professional Goodwill | | 400,000 | 206,000 | 103,000 | 51,500 | 25,750 | 12,875 |
| Practice Goodwill | 50% | 400,000 | 412,000 | 424,360 | 437,091 | 450,204 | 463,710 |
| Total Sales | | 800,000 | 618,000 | 527,360 | 488,591 | 475,954 | 476,585 |
| Profit (Cash Flow) | 25% | 200,000 | 154,500 | 131,840 | 122,148 | 118,988 | 119,146 |
| <i>Present Value Factor</i> | | | 0.93 | 0.81 | 0.71 | 0.61 | 0.53 |
| Present Value Of Net Cash Flow | | | 143,685 | 106,790 | 86,725 | 72,583 | 63,147 |
| Cumulative Present Value | | | | | | | 472,930 |
| Present Value Of Terminal Value | | | | | | | <u>542,016</u> |
| Indicated Value of Equity | | | | | | | 1,014,946 |